China’s Leadership Transition Social Stability May Require a Stronger Renminbi
**Introduction**

In 2012, China is poised to undergo a significant change in the official leadership structure of its country. Given that China maintains centralized government control over much of the country, even a marginal change in leadership composition may have deep and far reaching implications for the economy and investors globally. This report is aimed at analyzing the key implications from a global investor’s standpoint.

In the wake of its leadership transition, current and expected initiatives, in concert with economic realities and political dynamics, are likely to lead to the adoption of more flexible market dynamics and ongoing gradual strengthening of the Chinese currency. As a result of these trends, China is likely to grow into a global financial hub and an increasingly attractive place for global business.

**When the Butterfly Flaps its Wings**

To understand China’s political system, we first outline the key factions important to political decision making in China, namely the Communist Party of China (the Party) and its Politburo Standing Committee (PSC). Within the PSC, we pay particular attention to the implications of the Party’s diverging political dynamics. We then dissect the leadership transition, analyzing the personal backgrounds and political stances of the candidates set to succeed Hu Jintao and Wen Jiabao. While there will be sweeping change in official political posts, the likely implications on Chinese policy may be slight, given that incumbents will unofficially maintain significant influence subsequent to the leadership transition. However, any marginal change may have significant ramifications globally. We consider such marginal changes will move to place greater emphasis on the development of the domestic economy and China’s middle class, and the acceptance and adoption of greater free market forces to help manage inflation while maintaining Party control. We examine the steps China is taking to allow a more open market, specifically the internationalization of the Chinese currency, and its implications for global investors.

**The Party and its Politburo Standing Committee**

In the second half of 2012, the Party is set to hold its 18th National Congress and elect a new Central Committee. This new Central Committee will, in turn, appoint seven new members to the (currently) nine member PSC, which is arguably the most important leadership body in China, overseeing centralized government decision-making and yielding significant political control. The PSC is generally viewed as China’s core decision-making body.

Three major components comprise China’s political system: the Party, the State Council, and the Central Military Commission. Similar to the United States’ political system, China has three key branches, but that’s where the comparison ends. While the United States’ three branches (legislative, judicial, executive) are intended to exert power equally, and to balance each other, China’s key political decisions are centralized with the Party, represented at its highest level by the PSC; the PSC is responsible for political decisions, exerting absolute control over the other two branches. Top ranking officials of the State Council and Central Military Commission are themselves members of the Party and/or appointed by the Party to those positions. Indeed, there are over 80 million Party members nationally, making it the largest political organization in the world. In many respects, Party policies have distinctly shaped everyday Chinese life, and arguably culture – from the one-child policy to internal urban migration management; from the carefully planned infrastructure developments to the close regulation of certain industries and the plethora of state owned enterprises (each of which employs Party committees that oversee all decisions). Regardless of one’s stance regarding the Party’s policies, it is clear that it has played a pivotal role in
China’s modern-day development, and is likely to continue to do so over the foreseeable future.

While China has a highly centralized leadership structure, it is important to note that top Party leaders are careful not to place too much control in the hands of any one individual. Rather, decision-making is a collective effort, whereby present and former PSC members come to agreement after debating relevant issues behind closed doors. Many top Party officials have first-hand experiences with the negative consequences of an authoritarian regime where too much control was centered on one individual, as was the case during the Cultural Revolution. Such experiences have instilled today’s leaders to resolve issues through collaborative decision-making processes.

The PSC is presently composed of nine members, outlined below:

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<thead>
<tr>
<th>Order</th>
<th>Name</th>
<th>Description</th>
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<tbody>
<tr>
<td>1</td>
<td>Hu Jintao</td>
<td>Hu Jintao is presently the Paramount Leader (President) of the People’s Republic of China, Chief of the Party, General Secretary of the Party, and also serves as the Chairman of the Central Military Committee.</td>
</tr>
<tr>
<td>2</td>
<td>Wu Bangguo</td>
<td>Chairman and Party Secretary of the Standing Committee of the National People’s Congress.</td>
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<tr>
<td>3</td>
<td>Wen Jiabao</td>
<td>Probably more well known is Wen Jiabao, the current Premier and Party Secretary of the State Council of the People’s Republic of China. Wen is the face of China’s economic policies, typically being the individual who communicates and implements them. While it is unclear to what extent Wen exerts personal influence over China’s economic policies, given all policies appear to be a result of collaborative decision-making, he nonetheless is likely to wield great authority, in concert with other members of the PSC.</td>
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<tr>
<td>4</td>
<td>Jia Qinglin</td>
<td>Party Secretary and Chairman of the National Committee of the Chinese People’s Political Consultative Conference.</td>
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<tr>
<td>5</td>
<td>Li Changchun</td>
<td>Chairman of the Central Guidance Commission for Building Spiritual Civilization of the Communist Party of China.</td>
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<tr>
<td>6</td>
<td>Xi Jinping</td>
<td>Vice President of the People's Republic of China; Top-ranked Secretary of the Central Secretariat of the CPC; Vice Chairman of the CPC Central Military Commission; President of the Central Party School of the CPC. Xi Jinping is set to succeed Hu Jintao as President.</td>
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<tr>
<td>7</td>
<td>Li Keqiang</td>
<td>First-ranked Vice Premier of the State Council; Deputy Party secretary of the State Council. Li Keqiang is set to succeed Wen Jiabao as Premier and Party Secretary of the State Council of the People’s Republic of China.</td>
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<tr>
<td>8</td>
<td>He Guoqiang</td>
<td>Secretary of the CPC Central Commission for Discipline Inspection</td>
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<tr>
<td>9</td>
<td>Zhou Yongkang</td>
<td>Secretary of the CPC Central Political and Legislative Committee</td>
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Elections: Bottom-Up in Theory, Top-Down in Practice

Officially, the PSC is appointed by the Party’s Central Committee, from a Politburo of 25 members narrowed from hundreds of Central Committee members. These 25 members typically hold senior positions in one of the three key political branches. The Party’s National Congress, in turn, officially elects the Central Committee, once every five years. As such, the Central Committee is widely considered as the candidate pool of China’s future leaders. Also, the Party’s National Congress (of which there were 2,200 delegates in 2007) are elected by the over 80 million Party members nationally. While this election and appointment approach is officially described as a bottom-up process, in reality, we believe that each political appointment is driven by top-down decision-making. This is important not only in understanding China’s political process, but because of the significant implications on the upcoming leadership transition.

Importantly, the system for appointing the incoming PSC is not only dependent on the current standing PSC members listed above, but also heavily dependent on previous standing members, who, unofficially, hold substantial influence after their term has officially ended. Indeed, Hu Jintao’s and Wen Jiabao’s predecessors already selected their successors, Xi Jinping and Li Keqiang, respectively (both these individuals are already standing members of the PSC); in turn, Hu Jintao and Wen Jiabao will play a large part in selecting Xi Jinping’s and Li Keqiang’s successors. Likewise, present PSC members have large influence in deciding upon incoming PSC members, as well as the composition of the 25-member Politburo and the Party’s Central Committee, which in turn influences the National Congress’s composition. In short, while the leadership decisions at the highest levels of office largely take place behind closed doors and are not reflective of a bottom-up appointment structure, it is widely believed that the selection of Committee members is based on negotiations between retired and current leaders. The communicated “nominal” process and unofficial “actual” process of appointment are highlighted below:

1. Usually 5 to 9 members; currently 9 members.
2. The 25 members also hold top positions in the State Council, Party organizations, key provincial governments and military
3. Currently including 204 full members and 167 alternate members; number of members may change. Most of them are ministers, agency heads, provincial governors, Party organization chiefs, military generals, and CEOs of major state-owned enterprises.
4. Approximate number of delegates as of 2007. The last National Congress was the 17th National Congress held in 2007.
5. Approximate number of members as of December 2010.
18th National Congress

In the second half of 2012, the Party will hold the 18th National Congress and elect a new Central Committee. Seven of the nine current members of the PSC (including Hu Jintao and Wen Jiabao) will retire and be replaced by appointees from the 25-member Politburo – elected by the Central Committee. Xi Jinping and Li Keqiang are the only two members who will remain on the PSC. Xi Jinping will become the Paramount Leader (President) of the People’s Republic of China, while Li Keqiang is set to become the Premier of the State Council (No.’s 1 and 3 on the PSC, respectively).

The Party’s Diverging Political Dynamics

Relative to politicians elsewhere in the world, China’s Party member’s views tend not to diverge substantively, at least in public, as evidenced by the united front and unified positions communicated by the Party. That said, there appears to be an increased divergence in views amongst top Party leaders; however contradicting views and debate are only likely to be voiced away from the public eye. For sake of simplicity, we can generalize two political stances within the Party’s top leadership: right leaning, and left leaning.

The Party’s Right: Shanghai Clique & “Princelings”

Generally speaking, those politicians associated with previous President Jiang Zemin (Hu Jintao’s predecessor) tend to be considered more right leaning, as do a smaller number of individuals who come from powerful political families (referred to herein as Political Dynasties). Those associated with Jiang Zemin are often described as the Shanghai Clique, a reference to the suggestion that Jiang Zemin favored promoting those who worked within his municipal administration in Shanghai. Many in China refer to individuals coming from political dynasties using the unflattering term Princelings, an unsubtle remark reflecting the view that many of these individuals have risen to prominence primarily through nepotism, rather than personal aptitude.

Right leaning Party members tend to focus on advancing the economy through economic globalization, many focus overtly on exports as a key driver of economic growth (the coastal regions, such as Shanghai, benefit under such a model). They also appear less adamant about centralized government compared to their left leaning counterparts, but many are reticent to change the status quo. Xi Jinping, the incoming President, is considered to come from a Political Dynasty, though his views regarding the economy may differ from other members of the right leaning faction, given his background. While many tend to appear free market oriented, members of political dynasties have an inherent bias to expansion through state-controlled enterprises, as many of them hold positions of power within those very organizations.

The Party’s Left: Communist Youth League Clique

On the other hand, left leaning senior Party members are often associated with current President Hu Jintao and China’s Communist Youth League (CYL). Many held senior leadership positions at the CYL, where they were in charge of administering the organization nationally, promoting the Party’s doctrine for those aged between 14 and 28. These politicians tend to come from fairly modest family backgrounds; members are often viewed as populists, tending to believe in pursuing socialist ideals, such as reducing income disparities and regional differences, particularly in the interior of the country. While being strong advocates of a centralized government, they also appear to favor greater levels of democracy within the Party, as well as increased public decision-making.
Incumbent President Hu Jintao was a prominent leader within the CYL, as was Li Keqiang, the incoming Premier of State. Li Keqiang appears to hold similar views consistent with this faction (which we will elaborate in more detail below).

**Common Goal: Social Stability**

While there may be certain divergences in philosophy, the core tenet amongst the Party’s top leaders is to engender social stability in China. The heavily controlled dissemination of newsflow from the “Arab Spring” uprisings earlier this year has to be seen in this context, given the leadership’s fear the movement could spur similar populist revolts within China itself. This is not surprising: the 1989 Tiananmen Square tragedy remains a taboo subject in China to this day, yet is likely imprinted in the minds of many of today’s top leaders. At the time, high inflation, growing income disparities and mistrust of government officials, combined with revolutions in Eastern Europe, (which ultimately led to the collapse of the Soviet Union), contributed to Chinese protestors taking to the streets. Today, inflation is rising, income disparity is a growing issue, there is rising negative sentiment towards the “princelings”, and we have witnessed political uprisings in the Middle East. As we will argue, this common tenet of maintaining social stability may ultimately be a core driver of a stronger Chinese currency going forward, which may in turn have a substantial impact on investors’ global outlook.

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**Increasing Recognition of Global Education**

While all current and prospective PSC members were educated in China, many of today’s top leaders and potential top leaders have pushed their children to pursue degrees from internationally recognized Western Universities, as evidenced by prospective President Xi’s daughter, who is enrolled at Harvard University. Such a decision to send their children for Western education is telling. It may be an indication of a longer-term trend in which future Chinese leaders increasingly embrace the concept of globalization and have an understanding, if not an appreciation, for Western ideals. In contrast, many of China’s previous top leaders were educated internally within China, with very little international experience or exposure to international ideals and principles. The focus of education also appears to have changed; previous leaders tended to be engineering graduates, whereas prospective Party leaders, in aggregate, appear more rounded, with degrees in economics, law and engineering.

**Prospective Politburo Standing Committee**

We know the composition of the PSC post-transition will include Xi Jinping and Li Keqiang as two of the most influential members; the remainder of the PSC is less clear, but is likely to include an approximate equal mix of left leaning (CYL affiliated) and right leaning (Shanghai Clique/Political Dynasty affiliated) members. Notably, the incumbents Hu Jintao and Wen Jiabao, whom Xi Jinping and Li Keqiang will replace, are both associated with the CYL, while Xi Jinping is considered to hold a more right leaning view, while Li Keqiang is more left leaning.
Current Politburo Standing Committee

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<tr>
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<tr>
<td>Hu Jintao</td>
<td>Left (CYL Clique)</td>
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<tr>
<td>Wu Bangguo</td>
<td>Right (Shanghai Clique)</td>
</tr>
<tr>
<td>Wen Jiabao</td>
<td>Left (CYL Clique)</td>
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<td>Xi Jinping</td>
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<tr>
<td>Unknown</td>
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<td>Li Keqiang</td>
<td>Left (CYL Clique)</td>
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<tr>
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It should be noted that the Party closely monitors any and all dissemination of information on top leaders within its ranks. As a result, insights into the likely political and economic stance of both men are sparse – even where they sat on key decisions historically is generally not made publicly available. Nonetheless, their background and upbringing may give us some idea of the likely direction both men may want to see China heading in over the foreseeable future.

**XI JINPING: THE NOT-SO-DIPLOMATICAL FUTURE PRESIDENT**

Xi Jinping, an engineering graduate, is considered to come from a Political Dynasty and is generally associated with pro-growth policies. That said, his upbringing was quite different from that of other Party members who come from well-connected political family backgrounds. His father, Xi Zhongxun remains a controversial figure to this day, after lending support to the Tiananmen Square protests. Indeed, state run media avoid the topic of Xi Zhongxun altogether, likely because of the perceived negative implication that it may undermine Xi Jinping’s credentials as President. Xi Zhongxun was a vigorous proponent of economic and political reform. He previously held the position of Deputy Prime Minister in the early 1960s, but was accused of disloyalty to the Party and subsequently expelled as part of the Cultural Revolution. After “regaining favor” with the Party, he became the Governor of Guangdong, where he spearheaded the country’s first Special Economic Zone (SEZ), a model for which China’s recent economic transformation can be attributed.

Like all things political, not the least in China, Xi Jinping seems to realize that keeping his cards closely held to his chest may be advantageous. Observing the consequences of his father’s actions may be a key reason why he has intentionally steered clear of controversy and portrayed strong nationalistic sentiment. Nonetheless, he has implemented policies that mirror closely the ideals engendered by his father. For instance, while serving in key Party posts in the coastal provinces of Fujian and Zhejiang, he promoted a greater open market economy, increasing cooperation with Taiwan and other Asian nations, and implemented policies that incentivized private sector development, such as relaxation of market entry criteria, simplification of new business registration, and financing incentives. Recent remarks regarding international dynamics, while reflecting a strong sense of nationalism, appeared less than diplomatic. Regarding foreign criticism of China: “Some foreigners with full bellies and nothing better to do engage in finger-pointing at us. First, China does not export revolution; second, it does not export famine and poverty; and third, it does not mess around with you. So what else is there to say?”

sure to allow the currency to appreciate. Having said that, we believe the development of the domestic economy will ultimately require appreciation of the currency, which we elaborate on below.

It could be argued that Xi Jinping’s upbringing has brought him closer to the Chinese populace. As alluded to above, his father was a controversial figure, and as a result of expulsion during the Cultural Revolution, he spent many of his formative years in a rural village. He therefore may have an appreciation for many of the struggles faced in such regional areas. Moreover, he has first-hand knowledge of the implications of overly authoritarian Communist policies that resulted during the Cultural Revolution and thus may have a greater appreciation for the collective, albeit highly centralized, decision-making process promoted by the Party. While Xi Jinping may not harbor the same sense of privilege that is often associated with those coming from political dynasties, it appears there remains a strong incentive to keep the status quo of political influence administered by the Party. As such, we don’t consider Xi Jinping likely to implement any radical reforms over the foreseeable future.

**Li Keqiang: the Left-leaning Future Premier**

Li Keqiang is associated with the CYL and comes from a much less affluent background than Xi Jinping, or any other Party member from a political dynasty for that matter. He is widely viewed as a self-made man. After being sent to a rural labor camp during the Cultural Revolution, he joined the CYL, earned a law degree and, subsequently, a PhD in economics. His educational background itself distinguishes Li Keqiang from other top ranking Party officials, the majority of which come from an engineering background. He rose within the CYL, ascending to become a protégé of current President Hu Jintao. Many believe Li Keqiang to be Hu Jintao’s preferred successor, as opposed to Xi Jinping (above).

Li Keqiang appears to favor economic development programs that benefit regional areas and distribute wealth evenly; during his tenure as Governor of Henan Province, he implemented several policies aimed at incentivizing increased investment into the poorer inland regions and instigated comprehensive measures aimed at improving the economic development and employment situation of the province as a whole. He also provided policy incentives aimed at attracting talent and capital from the more affluent coastal areas. Notably, Li Keqiang has first-hand experience overseeing industrial and agricultural provinces, having held leadership positions in both Liaoning and Henan, giving him a good understanding of regional differences within the national economy as a whole.

We consider Li Keqiang to be more populist, with a focus on income disparity, particularly in regional areas, while retaining a strong focus on the development of the domestic economy and building the Chinese middle class. On the former, Li Keqiang has been actively involved in housing projects aimed at improving living conditions and has implemented unemployment insurance reform. His focus on the development of the domestic economy may be somewhat in contrast to that of many right leaning Party officials, who place more weight and reliance on the export sector as the driver of China’s ongoing growth. Combined with his strong affiliation to the CYL, we consider Li Keqiang will advocate socialist ideals through more populist policies, focusing on developing China’s middle class, while upholding the core tenets of the Party.

**Political and Economic Implications**

Ultimately, the leadership decision-making may change little immediately following the transition of power in 2012, as former leaders tend to hold great sway over political decisions after they officially vacate office. Case in point: it was over two years after current President Hu Jintao took office as President before he was widely
considered to wield greater control than his predecessor Jiang Zemin. Even so, Jiang Zemin is still likely to influence policy and appointment of high-ranking government officials, despite officially retiring as President in 2003. Likewise, Hu Jintao and Wen Jiabao are both likely to wield greater political clout than Xi Jinping and Li Keqiang in the immediate years following the leadership transition. The transition is likely to be managed closely; any change in political direction is only likely to be marginal. That said, any marginal change in direction might have significant ramifications for the world economy, given the increasing economic stature of China on the world stage.

With this in mind, any marginal change in policy may incorporate two key factors: increased focus on the development of the domestic economy, while concurrently moving towards more flexible market forces. With regard to the former, we consider Li Keqiang to be a proponent of domestic economic development, particularly those focused on closing income disparities, or, said another way: growth of a Chinese middle class. Xi Jinping’s background likely adds support to this notion. On the latter, we consider that economic and political realities will force Chinese policy makers to gradually adopt incremental steps towards freeing up market conditions, and specifically, allow the currency to appreciate. Xi Jinping, in particular, appears to understand the need for market reform, and we believe there is a general trend in the leadership structure towards greater acceptance of globalization, and towards a more flexible currency exchange rate.

Like Wen Jiabao has done, Li Keqiang is anticipated to represent the “face” of China’s economic policy, communicating and implementing any change in direction. As outlined above, it is likely that he will pay greater focus on developing the domestic economy and implementing programs designed to distribute wealth equally, particularly to poorer regions. Xi Jinping has a history of implementing pro-entrepreneurial policies in the coastal provinces of Fujian and Zhejiang. As a result, we believe the appointments of Xi Jinping and Li Keqiang may represent an incremental step towards placing greater focus on growing China’s domestic economy and middle class, rather than overtly relying on exports to drive sustainable economic growth going forward. Many in China continue to perceive exporting goods to U.S. consumers as the most important driver of Chinese economic growth, despite the fact that, for example, China exports more to the European Union. Notwithstanding, the recent financial crisis may have provided clear evidence that such an economic model is unsustainable. Both Xi Jinping’s and Li Keqiang’s personal experiences are likely to lead to a greater focus on the domestic economy. In their focus on the domestic economy, we expect a gradual shift away from attempting to micro-manage economic growth through infrastructure investments. Xi Jinping in particular is likely to consider incentivizing entrepreneurs to further build the domestic economy, and thus a middle class that can support domestic demand. Xi Jinping will likely find support from Li Keqiang on this front.

**Strong Currency Necessary to Support Social Stability**

We believe that to remain in power, the Party’s top leadership is incentivized, above all else, to maintain social stability. In this context, political and economic realities may dictate the Party to allow the currency to appreciate further.
From an economic perspective, key elements that contribute to the maintenance of social stability may include: generating ongoing, sustainable economic growth and maintaining price stability (mitigating inflationary pressures), such that the populace as a whole experiences real wage growth. On the latter point, and continuing the “Arab Spring” example, we would argue that commodity price inflation was a strong contributor to the populist uprisings experienced in the Arab region: democratically unelected leaders can stay in power as long as the populace can feed themselves; when commodity price inflation causes a loaf of bread to become too expensive, those in power risk a revolt of the populace. Allowing the Chinese currency to appreciate may help naturally mitigate some of the domestic inflationary pressures being experienced in China, such that a loaf of bread – or a bowl of rice – remains affordable for the populace.

From a currency perspective, we believe these dynamics support the notion that the Chinese will be forced into allowing a stronger Chinese renminbi (RMB). We should note here our view that the Chinese are unlikely to allow their currency to appreciate due to pressure applied by the U.S., or any other country for that matter (Xi Jinping’s quote above supports such thinking). Rather, we believe the Chinese will allow the currency to appreciate, to work as a natural valve in mitigating inflationary pressures, and in turn, help maintain social stability. Top-level Party members are keenly aware that inflation acts as a destabilizing effect on social stability. Indeed, Wen Jiabao recently stated that keeping consumer prices stable will remain the government’s top priority.7 Official inflation has been running above 5% for some time, with food and labor cost inflation substantially higher. Moreover, actual inflation is likely to be somewhat higher than the reported figures.

![China Food Inflation (YoY)](image)

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A strong Chinese currency may help dampen inflationary pressures. Imported commodity prices in local currency fall as the currency strengthens, and by any measure, China imports a substantial portion of global commodities. On the other hand, and as discussed above, many top leaders in China continue to hold the view that exporting goods to U.S. consumers is the most important driver of Chinese economic growth and have thus been reluctant to allow the currency to appreciate too quickly, for fear it would be detrimental for exports, and thus the overall economy. We consider these long-held views are splitting at the margin, as China now has pricing power in the goods it exports.

China’s Pricing Power

We consider China has increasingly moved up the value chain in terms of goods produced. As a result, China now has greater pricing power and therefore a greater ability to pass on increased costs of production, via an appreciation of the RMB. Dynamics in the U.S. and abroad have only increased China’s pricing power. Leading up to the financial crisis in 2008, U.S. consumers and corporations alike leveraged themselves up too highly, incentivized by low interest rates and taxes. This artificially propped up consumer spending while real wages stagnated. In what became a self-reinforcing cycle, corporate America found itself caught in the middle. With weak real wage growth hampering top-line sales appreciation, U.S. businesses were forced to implement cost-out and margin enhancement initiatives to boost the bottom-line. Increased levels of outsourcing to manufacturers in Asian countries, particularly China, transpired. Over time, China absorbed increasingly complex manufacturing processes, as U.S. corporations outsourced evermore. This trend appears to continue to this day: earnings announcements for the third quarter of 2011 showed that approximately ¾ of S&P 500 companies surprised on bottom-line earnings, while just over half surprised on top-line sales: margin enhancement continues to be a key driver of corporate profitability.

At the other end of the spectrum, China has allowed some of its low-end manufacturers, such as the toy industry, to fail and migrate to low-cost producing countries, like Vietnam. This trend up the value chain was recently typified by China’s decision to consider investing RMB10 trillion (approximately US$ 1.6 trillion) over the next five years in a number of value-add industries, such as biotechnology and high-end equipment manufacturing. Notably, both Xi Jinping and Li Keqiang, while holding high ranking Provincial positions, implemented policies that promoted increased pricing power, encouraging greater value-added businesses.

With increased pricing power comes an enhanced ability to pass on price increases. Combined with the increased importance of the domestic economy and lower reliance on foreign markets, we believe China is in a strong position to allow its currency to appreciate relative to the U.S. dollar. The implications, from a U.S. standpoint, point towards greater inflationary pressures via import price inflation, and further pressure on the dollar. Indeed, many U.S. corporations and importers have recently voiced concerns surrounding significant price increases out of China. Chinese exporters clearly can no longer stomach the increased costs of doing businesses brought about by commodity and labor cost pressures, and are in turn learning that they have the ability to pass on these costs. Likewise, Chinese policy makers may increasingly realize that allowing the currency to appreciate may be a more effective way to mitigate domestic inflationary pressures as opposed to imposing restrictions on bank lending or price controls, which has been the preferred choice over recent periods.

Steps to Internationalize the Renminbi

It is highly improbable that the Chinese will allow its currency to float overnight; after all, such drastic action would immediately impose additional risks on Chinese businesses and the economy. That said, recent evidence suggests policy makers are moving to internationalize the RMB. Indeed, Chinese policy makers have implemented a number of policies to promote its international use, including cross-border RMB settlement, the development of an offshore RMB-denominated bond market, bilateral swap agreements, and onshore trading of the RMB against an increasing list of currency pairs.
In 2010, personal and business bank customers in Hong Kong were allowed near-unrestricted interbank and inter-account RMB transfer capabilities. Additionally, in early 2011, Chinese authorities allowed Chinese corporations to use RMB to launch businesses overseas and fund acquisitions. As a result, RMB deposits in Hong Kong surged to RMB622.2 billion in September 2011, from RMB149.3 billion a year earlier; monthly remittance for RMB trade settlement through Hong Kong banks expanded from RMB30.0 billion to RMB190.6 billion during the same time period.\(^8\)

![Monthly Renminbi Deposits in Hong Kong](image)

Since 2007, China has allowed mainland banks to issue offshore RMB-dominated bonds in Hong Kong, commonly referred to as “dim sum” bonds. The market has grown rapidly, particularly after China allowed Chinese corporations to use RMB to launch businesses overseas and fund acquisitions. These corporations found ready demand for such issuance, from many international investors seeking exposure to the RMB. Indeed, many bond issues have been significantly over-subscribed. Total cumulative issuance of dim sum bonds since 2007 was approximately RMB208.1 billion as of October 2011. Notably, in 2011 alone, year-to-date issuance through October (RMB134.4 billion) was almost twice that seen in the preceding four years (RMB73.7 billion).\(^9\)

![2007-2011 Dim-Sum Bond Issuance](image)

\(^8\) Source: Hong Kong Monetary Authority

\(^9\) Source: Bloomberg
With the decision in early 2011, we have witnessed a wider range of issuers. Compared to 2007 and 2008, when only major Chinese state-owned commercial and policy banks issued dim sum bonds, in 2011 international entities accounted for 16.8% of total issuance. China’s Ministry of Finance issued the first sovereign dim sum bond in 2009; McDonald’s became the first foreign corporation to issue dim sum bonds in 2010. It now appears that China’s Shanghai Stock Exchange is readying itself to allow foreign companies to issue stock, allowing access to the second largest equity market in the world.

In addition to the RMB trade settlement program, China has also signed a series of bilateral currency swap agreements with a broad range of countries to help mitigate the reliance on U.S. dollars, while concurrently promoting the RMB as a global currency. The first two agreements were signed with South Korea and Hong Kong in late 2008. China has since expanded its swap agreements to include major Asian trading partners, as well as Argentina, Iceland, and New Zealand. Many of these agreements have also been increased from their original size. As of November 2011, China had signed bilateral currency swap agreements for 12 currencies, totaling an amount of RMB 1.2 trillion.  

![China's Bilateral Currency Swap Lines](image)

We have also seen China allowing the RMB to trade against a greater number of currencies. The recent announcement to allow RMB to trade against the Australian and Canadian dollars brings the total list of currencies that the RMB trades against onshore to nine, the others being: the U.S. dollar, the euro, the British pound, the Japanese yen, the Hong Kong dollar, Malaysian ringgit, and the Russian ruble. We consider all of these steps to be incremental in the overall process towards a more free floating, internationalized Chinese currency. These initiatives also push China closer towards becoming a legitimate global financial center, providing increased incentives to attract capital from abroad. As a further sign that international acceptance of the RMB is making progress, note that the Chicago Mercantile Exchange (CME) recently announced that it will accept RMB to be used as collateral for futures contracts.

10 Source: People’s Bank of China
Many of these initiatives point to ongoing appreciation of the currency. Indeed, the Chinese have conducted multiple scenario analyses focused squarely on the implications of a stronger currency on local businesses; analysis was conducted directly before the decision was made to allow the currency to resume its appreciation versus the dollar in 2010. Having said that, not all market participants agree that the RMB will continue to appreciate; and certainly, the RMB does not appreciate every single day. Should inflation persist, it may, over time, erode the appreciation potential of the RMB. Indeed, increasing market disagreement over the direction of the RMB may, expedite a move towards a free-floating currency. After all, policy makers will be reluctant to allow a free-floating currency if “everyone” believes the RMB must appreciate, thereby creating asymmetry in the marketplace. Importantly, it requires buyers and sellers to make a free float work.

**Conclusion**

Any marginal change in the governance of China is likely to have far reaching implications. Most notably, we expect an increased focus on developing the Chinese middle class and domestic economy over time, with less reliance on the export sector. In turn, political and economic realities are likely to force Chinese policy makers to allow the RMB to appreciate, to help manage domestic inflationary pressures, and thus maintain social stability. We consider that China has the ability to allow its currency to appreciate and put in place steps towards a free-floating framework, due to increased pricing power resulting from manufacturing of a wider range of value-added goods. Indeed, we have seen steps put in place to ready the country for appreciation of the currency, including conducting scenario analyses on local businesses, while concurrently increasing the internationalization of the currency. China is likely to become a global financial hub and a more attractive place for global business, as a bi-product of such initiatives. Such dynamics are likely to lead to ongoing strengthening in the Chinese currency over the foreseeable future.

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**About the Authors**

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